No.

In the Supreme Court of the United States

OCTOBER TERM, 1952

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, affirming the judgment of the Tax Court.

OPINIONS BELOW

The opinion of the Tax Court (R. 30-35) is reported at 11 T.C. 174. The affirming order of the Court of Appeals (R. 45) is reported at 194 F. 2d 536.

JURISDICTION

The judgment of the Court of Appeals was entered on February 12, 1952. (R. 45.) A petition

for rehearing, filed on March 1, 1952, was denied on April 11, 1952. (R. 46-48.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

In the taxable year 1943, taxpayer received compensation under a claim of right and reported the amount received in his return for that year. In a later year, as a result of litigation, it was adjudicated that the compensation was excessive and that, to the extent of the amount determined to be excessive, taxpayer was liable as a transferee for tax claims against his employer. May taxpayer's 1943 return be reopened to recompute his tax by excluding from his income for that year the amount of compensation subsequently held to be excessive and subject to transferee liability?

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 42.)

STATEMENT

The facts as stipulated (R. 27-30) were adopted by the Tax Court as its findings (R. 31-33). They may be summarized as follows:

During 1942 and 1943, the taxpayer was the president and sole stockholder of the Charles E. Smith & Sons Company (hereinafter called the Company). For its 1942 and 1943 fiscal years the Company paid to taxpayer for his services a salary of $52,000 and $87,265.08, respectively, and deducted these amounts in its income and declared value excess profits tax returns for those years. Thereafter, the Commissioner determined that these amounts exceeded a reasonable allowance for compensation for taxpayer's services to the extent of $27,000 for 1942 and $57,265.08 for 1943, and that to the extent of these excessive payments taxpayer was liable as transferee for the Company's tax deficiencies. The Company and the taxpayer each contested the Commissioner's determinations, and filed petitions with the Tax Court, which were consolidated for hearing. In the proceeding brought by the Company, the Tax Court sustained the Commissioner's disallowance of a portion of taxpayer's compensation for both 1942 and 1943. In the proceeding brought by taxpayer, it held that he was liable as a transferee for the unpaid taxes of the Company to the extent of the excessive compensation he received for 1943, since the payment in that year rendered the Company insolvent. The Tax Court's decisions were entered May 28, 1948. (R. 27-29, 31-32.) Both the Company and taxpayer appealed, and the Tax Court's decisions were affirmed by the Court of Appeals for the Sixth Court on October 20, 1950. *Charles E. Smith*

& Sons Co. v. *Commissioner*, 184 F. 2d 1011. Certiorari was denied March 26, 1951. 340 U.S. 953.

Taxpayer reported the full amounts of salary received from the Company in 1942 and 1943 in his income tax returns for those years, and paid the tax shown to be due thereon. He received these amounts under a claim of right, and has ever since retained them. He had no knowledge of the proposed disallowance of a portion of these amounts as a deduction to the Company until September 1944. In January 1947 he filed a claim for refund of part of the tax paid on his 1943 return, on the ground that he was not taxable on such portion of the compensation he had received and reported in that year as might finally be determined to be excessive and subject to transferee liability. The claim for refund was denied by the Commissioner. (R. 29, 32.)

The Tax Court held that taxpayer's tax liability for 1943 should be recomputed by excluding from the compensation he received and reported in that year such portion as might finally be determined to be excessive and subject to transferee liability.[1] (R. 33-35.) The Court of Appeals affirmed on the authority of *Commissioner* v. *Wilcox*, 327 U.S. 404

[1] The Tax Court's opinion herein was promulgated August 16, 1948 (R. 30), and its decision was entered October 26, 1948 (R. 36), both of which dates antedated the final adjudication in 1951 (184 F. 2d 1011 (C.A. 6th), certiorari denied, 340 U.S. 953) of whether and to what extent taxpayer was liable as transferee.

(R. 45), and denied the Commissioner's petition for rehearing. (R. 46-48).

REASONS FOR GRANTING THE WRIT

1. The decision below is plainly contrary to this Court's rulings in *United States* v. *Lewis*, 340 U.S. 590, and *North American Oil* v. *Burnet*, 286 U. S. 417, and is in direct conflict with the decisions in *Commissioner* v. *Hartfield*, 194 F. 2d 662 (C.A. 2), and *Fleischer* v. *Commissioner*, 158 F. 2d 42 (C.A. 8). The Court of Appeals for the Second Circuit, in *Commissioner* v. *Hartfield, supra*, rejected a claim indistinguishable from that of the taxpayer in this case with the short observation that "citation of North American Oil v. Burnet, supra, and U. S. v. Lewis, supra, would seem to be sufficient to demonstrate that" the attempt to reopen a tax return for a prior year because of subsequently accrued transferee liability must fail. 194 F. 2d at 663.[2] The judgment of the Tax Court in the pres-

[2] Similarly in direct conflict with the decision below is the Eighth Circuit's decision in *Fleischer* v. *Commissioner, supra*, relied upon by the Second Circuit in *Hartfield*. In the *Fleischer* case, the taxpayers were corporate officers whose salaries for 1941, which they reported and on which they paid taxes for that year, were ruled to have been excessive and were disallowed in part as a deduction to the corporation in 1943. On the advice of counsel, the taxpayers repaid to the corporation a sum equal to the resulting deficit in the corporation's balance sheet and then sought refunds of their 1941 taxes on the theory that they had received the amounts subsequently repaid "as constructive trustees and subject to an obligation to restore them to the corporation if its capital became impaired." That theory, adopted below in the instant case, was rejected by the Eighth Circuit on the authority of *North American Oil* v. *Burnet, supra*.

ent case, as in *Hartfield*, was rendered prior to this Court's decision in *United States* v. *Lewis*. In its brief order of affirmance, the court below omitted any reference to the intervening *Lewis* decision by this Court and relied exclusively upon *Commissioner* v. *Wilcox*, 327 U. S. 404, which was distinguished in *Lewis* (340 U. S. at 591-592) and has since been limited "to its facts" in *Rutkin* v. *United States*, 343 U. S. 130, 138.

2. The decision below is irreconcilable with the rule of the *Lewis* and *North American Oil* cases that income received under a "claim of right" is taxable to its recipient in the year of receipt or accrual "even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." *United States* v. *Lewis, supra*, at 591, quoting and reapplying the language of *North American Oil* v. *Burnet, supra*, at 424. In the *Lewis* case a taxpayer-employee reported in his 1944 income tax return compensation he had received in that year under a claim of right. As a result of subsequent litigation, it was determined that he had had no valid claim to a portion of the compensation because it had been erroneously computed, and in 1946 he refunded the excess to his employer. This Court sustained the Government's contention that the taxpayer could not reopen and recalculate his 1944 tax liability so as to exclude from his income for that year the subsequently repaid portion of his compensation, but should have

deducted the repayment as a loss in his 1946 return. The Court stated (340 U. S. at 591-592):

> In the *North American Oil* case we said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." 286 U. S. at 424. Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. * * *
>
> Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C., §§ 41, 42; and see *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.

Here, as in *Lewis*, the taxpayer received compensation under a "claim of right," reported it and paid the income tax on it for the taxable year of receipt, and was required to relinquish part of it in a subsequent year because of litigation resulting in a determination that his compensation had been excessive. It is immaterial that in this case the

taxpayer's subsequent liability to restore part of his compensation was imposed upon him as a "transferee" in equity and accrued to the benefit of his employer's creditor (the Government) rather than directly to the employer. All that matters here, as in *Lewis*, is the fact (stipulated in this case) that the taxpayer received the compensation in the earlier year "under a claim of right and has ever since retained" it (R. 29). Indeed, even if he had knowingly obtained the compensation under a false or invalid claim, he would have been required to report it and pay the tax on it in the year of its receipt. *Rutkin* v. *United States, supra.*

The decision below proceeds upon the theory that the taxpayer, in the light of the judgment years later that he was liable as a transferee, had received his compensation in 1943 subject to an immediate and unconditional obligation to relinquish a portion of it in satisfaction of the Government's tax claim against his employer (R. 34-35).[3] But this theory rests upon a misreading of the undis-

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[3] The Tax Court also suggested (R. 35) that "injustice" would result unless taxpayer were permitted to reopen his 1943 return so as to exclude the portion of the compensation later found to be excessive and subject to transferee liability. In the *Lewis* case this Court rejected the same argument (340 U. S. at 592 n.):

> It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I.R.C., § 322 (b).

puted facts and, as is illustrated by the conflicting decisions in *Commissioner* v. *Hartfield* and *Fleischer* v. *Commissioner, supra,* departs from the controlling principles settled by this Court. The taxpayer's liability as transferee, nonexistent and presumably unsuspected when he reported and paid the tax on his 1943 income, arose only after it had been finally determined, much later, that (1) his compensation had been excessive, (2) his corporate employer had been rendered insolvent by the payment, and (3) the employer owed additional taxes to the Government. First apprised in September of 1944 that a part of his compensation for 1943 might be held to have been excessive (R. 29), the taxpayer strenuously contested his potential liability in litigation extending into the year 1951. *Charles E. Smith & Sons Co.* v. *Commissioner,* 1947 P-H T. C. Memorandum Decisions, par. 47,128, affirmed, 184 F. 2d 1011 (C.A. 6), certiorari denied, 340 U. S. 953. These unquestioned facts cannot be reconciled with the notion that the taxpayer received his compensation in 1943 subject to an immediate liability to repay a portion of it. Cf. *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516; *Lucas* v. *American Code Co.,* 280 U. S. 445.[4]

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[4] Disposing of the same issue in *Commissioner* v. *Hartfield, supra,* the Court of Appeals for the Second Circuit said (194 F. 2d at 663):

> The liability of the taxpayers as transferees must necessarily have awaited the determination as to the existence and amount of the excessive salary payments. It was not fixed in 1945. Even though corporate in-

In short, it is clear that the taxpayer in this case properly reported and paid income tax on his 1943 compensation. His subsequent liability to relinquish the equivalent of part of that compensation affords no ground for reopening and recalculating his tax for 1943. For the subsequent liability cannot operate here, any more than it did in *United States* v. *Lewis, supra,* to erase retroactively the dispositive fact that the compensation in question was received "under a claim of right and without restriction as to its disposition * * *." 340 U. S. at 591.

3. Because the error in the decision below seems plain, and because the stipulated facts present no need for further exposition in briefs and argument, the Government respectfully submits that this is an appropriate case for summary reversal on the authority of the *Lewis* and *North American Oil* decisions. We submit, in any event, that the decision below of the recurrent question in this case, conflicting squarely with decisions of the Second and Eighth Circuits,[5] requires review by this Court.

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solvency were admitted, the liability of the officers did not exist until excessive payments were determined as a fact, and it was established that a deficiency in the corporate tax existed.

[5] It should be noted that, in addition to the direct conflict with the *Hartfield* and *Fleischer* cases, the decision below is incompatible with the premise accepted in *Commissioner* v. *Arrowsmith*, 193 F. 2d 734 (C.A. 2), and *Commissioner* v. *Switlik*, 184 F. 2d 299 (C.A. 3). In those cases stockholders who reported capital gains on corporate liquidations were in later

CONCLUSION

The petition for a writ of certiorari should be granted and the decision below reversed on the authority of *United States* v. *Lewis*, 340 U. S. 590, and *North American Oil* v. *Burnet*, 286 U. S. 417.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

JUNE, 1952.

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years adjudged liable as transferees for claims against the corporations. Both decisions assumed that the returns for the years in which the gains were reported could not be reopened to reflect the transferee liability, and the only issue litigated was whether the payments satisfying this liability were to be deducted in the year of payment as capital or ordinary losses. On this issue the two decisions are themselves in conflict, and the taxpayer in *Arrowsmith* has filed a petition for a writ of certiorari, No. 753, this Term.